

Wall Street Says -2 + -2 = 4 as Liabilities Get New Bond Math

By Bradley Keoun

June 2 (Bloomberg) -- Leave it to Wall Street to profit from its own distress.

Merrill Lynch & Co., [Citigroup Inc.](#) and four other U.S. financial companies have used an accounting rule adopted last year to book almost \$12 billion of revenue after a decline in prices of their own bonds. The rule, intended to expand the "mark-to-market" accounting that banks use to record profits or losses on trading assets, allows them to report gains when market prices for their liabilities fall.

The new math, while legal, defies common sense. [Merrill](#), the third-biggest U.S. securities firm, added \$4 billion of revenue during the past three quarters as the market value of its debt fell. That was the result of higher yields demanded by investors spooked by the New York-based company's \$37 billion of writedowns from assets hurt by the collapse of the subprime mortgage market.

"They can post substantial gains as a result of a decline in their own creditworthiness," said [James Cataldo](#), a former director of treasury risk management for the Federal Home Loan Bank of Boston and now an assistant professor of accounting at Suffolk University in Boston. "It's completely legitimate, but it doesn't make sense by any way we currently have of thinking of net income."

The paper profits have helped offset more than \$160 billion of writedowns taken by U.S. financial-services companies during the past year. Now some investors and analysts say the winnings are illusory and may have to be reversed.

"The piper will have to be paid eventually," said [Robert Willens](#), a former Lehman Brothers Holdings Inc. accounting analyst who left the New York-based firm earlier this year to become an independent consultant.

Statement 159

The debate over what is known as Statement 159 adds to the number of accounting techniques called into question as the U.S. debt market unravels. Investors have criticized banks for booking some writedowns in an accounting category called "other comprehensive income" that bypasses their income statements. Accounting rulemakers are now proposing changes to standards that let banks use off-balance-sheet vehicles to juice earnings without tying up precious capital.

Statement 159, formally known as the "Fair Value Option for Financial Assets and Financial Liabilities," was issued in February 2007 by the Financial Accounting Standards Board, or FASB, which sets U.S. accounting rules. It was adopted by most large Wall Street firms in the first quarter of last year and becomes mandatory for all [U.S. companies](#) this year, although they have wide latitude in how to apply it, if at all.

Lobbying Effort

The rule was enacted after lobbying by New York-based companies, led by Merrill, [Morgan Stanley](#), Goldman Sachs Group Inc. and Citigroup, which wrote letters to FASB arguing that it wasn't fair to make them mark their assets to market value if they couldn't also mark their liabilities.

“We do not believe it would be appropriate” to let investors consider creditworthiness when valuing bonds if the issuing company couldn't do the same, wrote [Matthew Schroeder](#), managing director of accounting policy at Goldman, the largest U.S. securities firm by market value, in an April 2006 letter.

Companies are allowed to decide for themselves which of their outstanding bonds, loans and other liabilities will get mark-to-market treatment. That's an unprecedented degree of leeway, said Willens, who is also an adjunct professor at Columbia University in New York.

“It's kind of a dumb rule,” Willens said. “In the entire panoply of accounting, this is the most flexible and elective and optional rule that we have.”

The Fed Objects

Here's how it works, according to [Richard Bove](#), an analyst at New York-based Ladenburg Thalmann & Co. A company decides to designate \$100 million of its subordinated bonds as subject to mark-to-market accounting. The price of the bonds drops to 80 cents on the dollar from 100 cents. So the firm books \$20 million on the “presumed savings that you have on your liabilities,” Bove said.

“In the real world you didn't save a dime,” he said. “You still owe the \$100 million. It's another one of these accounting rules that basically takes you further and further away from reality.”

The Federal Reserve, Federal Deposit Insurance Corp., Office of the Comptroller of the Currency and Office of Thrift Supervision objected to the rule before its passage, saying in a joint 2006 letter to the FASB that it would “have the contrary effect” of increasing a bank's net worth at the same time its “financial condition is deteriorating.”

Split at FASB

The regulators remain so skeptical that they refuse to let banks apply the phantom revenue toward minimum capital requirements, according to reporting rules posted on the Web site of the Federal Financial Institutions Examination Council. [Deborah Lagomarsino](#), a Washington-based spokeswoman for the Federal Reserve, declined to comment.

Not even the FASB was united on the new standard. Two of its seven board members -- [Thomas Linsmeier](#) and [Donald Young](#) -- voted against it, according to the February 2007 statement. Linsmeier said the rule “will provide an opportunity for entities to report significantly less [earnings volatility](#) than they are exposed to,” according to the statement.

The FASB tried to limit abuses by forcing companies to designate their “fair value” liabilities when they adopt the new standard. Subsequently, they can't change their minds. Liabilities added after adoption can only be designated at inception.

“The statement was thoroughly discussed with users and preparers” in advance of its publication, said [Neal McGarity](#), a spokesman for Norwalk, Connecticut-based FASB. A March survey by the CFA Institute, a Charlottesville, Virginia-based group that administers a financial-analyst designation program, showed that 74 percent of investors believe the standard “has improved market integrity,” he said.

Merrill's Liabilities

[Merrill](#) designated about \$166 billion of liabilities, or 17 percent of its total, as fair-value instruments subject to mark- to-market accounting at the end of 2007, according to its annual report. Included in the amount were \$76.3 billion of long-term borrowings and \$89.7 billion of payables under securities- financing transactions.

Prices for the firm's bonds tumbled over the past year: Its floating-rate notes due in January 2015 are trading at about 87 cents on the dollar, compared with about 100 cents last June.

Merrill has said its gains from the liabilities don't add to true earnings power. In a spreadsheet posted on its Web site, [Merrill](#) says that investors who want a “more meaningful period- to-period comparison” should exclude the \$2.1 billion of revenue recorded in the first quarter.

Merrill spokeswoman [Jessica Oppenheim](#) declined to comment. The company owns a passive 20 percent stake in Bloomberg LP, the parent of Bloomberg News.

Lehman to Goldman

[Lehman](#), the fourth-biggest securities firm, has reported \$1.9 billion of gains related to a widening of its own bond spreads. [Citigroup](#), the largest U.S. bank by assets, has booked \$1.7 billion; Morgan Stanley \$1.7 billion; [JPMorgan Chase & Co.](#), the third-biggest bank, \$1.7 billion; and Goldman Sachs \$550 million.

There may be more to come, JPMorgan analyst [Kenneth Worthington](#) wrote in a May 28 report. Lehman may book \$325 million for the second fiscal quarter ended in May, and [Morgan Stanley](#), the second-biggest U.S. securities firm, may report \$470 million, Worthington estimates.

Spokesmen for Lehman, Morgan Stanley, Goldman, Citigroup and JPMorgan in New York declined to comment.

'Shell Game'

So far, most banks' writedowns are “unrealized,” meaning they've been unwilling or unable to liquidate distressed assets. If prices reversed, [the banks](#) would record mark-to-market profits.

The same is true for the liabilities. Companies can't “realize” the mark-to-market gains on their debt unless they buy it back at the discounted price. They're unlikely to do so, because the deterioration in creditworthiness means they'd have to replace the debt with higher-cost borrowings, Willens said.

“No one's going out in the market and actually retiring this debt,” Willens said. “It's a shell game.”

David Moser, Merrill's managing director for accounting policy, acknowledged that concern in an April 10, 2006, letter to the FASB.

“It seems counterintuitive that when a company's credit spreads are widening, it would recognize a gain in earnings,” Moser wrote. “The amounts are typically not realizable and therefore less relevant.”

He nevertheless supported the new accounting standard because it “mitigates some of the uneconomic volatility in [earnings](#)” that results from marking assets to market without doing the same for liabilities.

Market Reversal

[Bear Stearns Cos.](#), which adopted the new standard this year, reported a \$305 million windfall in the fiscal first quarter, which ended in February, as bond spreads widened on concerns the company might face a funding shortage. Then in March, after the New York-based securities firm was forced to sell itself to JPMorgan, Bear Stearns's bond spreads tightened, resulting in a \$372 million loss, according to a regulatory filing in April.

Worthington estimates that similar tightening of bond spreads at Merrill, Morgan Stanley, Lehman and [Goldman Sachs](#) may cause them to reverse \$5.96 billion of revenue by the end of the year.

“It could very well hurt earnings,” said [Jeffery Harte](#), an analyst at Sandler O'Neill & Partners LP in Chicago, in an interview. On the flip side, a recovery may result in asset write-ups, he said.

Standard & Poor's, which relies on banks' financial statements to issue credit ratings, said in April 2006 that the new rule might lead to “diminished analytical transparency.”

“Equity may be overstated as a result of these illusory gains that may never be realized, hindering the analysis of the equity cushion to absorb losses,” S&P Chief Accountant [Neri Bukspan](#) wrote in a letter to the FASB.

If and when the “illusory” revenue is reversed as losses, the banks and brokers may have to work harder to convince investors to ignore them, Willens said.